NOTES

WASHINGTON NOTES

THE NEW WAR LOAN

During the past month plans for floating the great loan provided for by Congress have assumed definite shape, and the process of actually securing subscriptions to the bonds is now well under way. Whether regarded as an independent financial operation, unprecedented in size and in the conditions under which it was undertaken, or whether it be considered as simply the first step in the process of financing our present European contest, the loan is of unusual interest to financiers and students of economics. It comes at a time which presents many peculiar aspects of banking and credit, and must succeed under conditions that in other circumstances would possibly be regarded as forbidding any real progress. The amount now offered is $2,000,000,000.

The loan has taken shape as a 3½ per cent security offered in denominations running down to $50, containing the proviso that it may be refunded into higher-rate bonds at any time in the future when the government finds itself compelled to put out a new issue under terms more favorable to the borrower, redeemable or refundable after 15 years but running not to exceed 30 years, and without the so-called "circulation privilege." Perhaps the most interesting aspect of the offering is found in the conditions of national credit under which it is placed on the market. Great Britain, whose borrowing power is apparently better than that of any of the other belligerent countries, has been obtaining funds in this country upon loans amply protected by collateral notes varying around 6 per cent. During the war she has been able to obtain immense sums of money, her debt, everything included, being now in the neighborhood of $18,000,000,000, or probably more than five times what it was before the war. Other European countries have followed her example. All have, meanwhile, come to the United States for the purpose of meeting necessities of capital, food, money, clothing, and munitions. Their credit has now substantially given out, and the government of the United States has assumed the responsibility of practically sustaining their military operations by enabling them to buy what they need in this country on credit. Under these conditions the question is well worthy of consideration, What is the extent to which the United States can go in meeting these demands? The special importance of the problem is found in the fact that the United States today is the last reservoir of liquid capital in the world; in other words, nowhere outside of its own boundaries can it borrow in considerable amount. It will not have an "external" war debt, because there are, to all intents and purposes, no countries that are in position to take up its bonds. Its debt must be almost exclusively domestic. In this respect its condition is more closely parallel to that of Germany than to that of any other country, inasmuch as Germany has in the same way financed herself entirely from within, both her financial connections and her import and export trade having been practically shut off very early in the war. The real question for the United States, as for Germany today, is how far annual production exceeds annual consumption; that is to say, what is the annual economic surplus? It can conceivably take by taxation or by borrowing the total amount of this surplus, and can devote it to the needs of the Allies abroad, or to the support of men unproductively employed at home in military occupations. More than this it cannot do, for the reason that what is wanted in this case is not money, or security, or credit, but the actual goods and services that are useful in the maintenance of the war and of military forces at home and abroad. There is no trustworthy estimate of the annual surplus of production over consumption in the United States. Our ownership of wealth is variously estimated at from $180,000,000,000 to $220,000,000,000, and on this principal an annual net earning at 5 per cent would be, say, $10,000,000,000. Various estimates placing our annual investable surplus at from $5,000,000,000 to $10,000,000,000 are current, but the amount is likely to be nearer the former than the latter figure. The present conditions of consumption and expenditure among all classes being considered, $5,000,000,000 to $10,000,000,000 may be regarded as the actual amount that could be supplied if we were to devote our annual savings entirely to the conduct of the war.

BORROWING POWER OF THE NATION

To attempt to give more than this annual surplus would have the result only of an apparent or fictitious acquisition of means by the government. If, for example, the Treasury were to be extended credit by banks to an amount which, combined with the contributions of the community above the total obtained through loans and taxation, amounted to more than the annual surplus of wealth, the result would be simply the making of an artificial demand for goods which did not exist, with a consequent advance in prices, so that the goods actually produced would be equal, at their new level of prices, to the funds offered for them. This method of borrowing would not result in getting more, because there would be no more to get, in the way of goods, but it would inflict greater hardship upon the community. The result would be self-enforced economy due to the fact that everyone would have to pay higher prices and would consume less than before.

Eventually it might be possible thus to acquire a greater amount of surplus wealth available for the uses of the government, but only through a difficult and painful process. These fundamental economic conditions set the limit to the real success of the government financing that is now being undertaken.

On the other hand, it being assumed that the aggregate amount of the loan to be floated is carefully and scientifically ascertained and fixed at a point that is not excessive and does not represent an effort to take from the public more than it can properly part with, there is yet a very serious problem to be met in determining and applying the methods by which the annual productive surplus of the country is to be taken over. The process of acquiring the total annual surplus output of a great nation cannot, of course, be exactly accurate, and involves serious dangers of maladjustment and error. The first problem to be disposed of is that of avoiding any disturbance to existing values more than can be helped, and particularly of avoiding disturbance to banking institutions. Discussion based on the experience of England in the present war has made it seem axiomatic that government bonds should not be placed in the hands of commercial banking institutions any more than can be avoided, but that they should be located as early and in as large proportion as practicable with the ultimate holders, whether these be savings banks or private investors. In appealing to private investors the government has to bear in mind that such possible investors are divisible into several classes. They may be investors who already own a given volume of securities, but who are willing to dispose of these securities in order to obtain means with which to buy government bonds. Such sales of existing securities mean that the power of those who take them up to buy bonds is itself curtailed to a corresponding extent. If it be assumed, therefore, that the persons who are induced to buy these old securities would have bought government bonds instead, the sale is really a transfer or shift whereby the government securities have taken their place in the hands of the investors who formerly owned such privately issued bonds. On the other hand, again, the buyer of the bonds may be an individual who purposes to pay for them out of his current income, either on the instalment plan or by obtaining from his bank a temporary loan which enables him to carry the new securities until he can pay off what is due. Again, the bond buyer may not wish to sell his old securities, but may have obtained a semipermanent loan protected by them from the bank, the proceeds of which he uses to purchase government bonds. Clearly, in all of these cases, the transaction, viewed from the broad economic point of view, is a change of ownership, except in those instances where the purchase of the bonds represents a real investment out of current income made by the recipient of such income, who abstains from the use of it. Anything else is a mere financial shift or readjustment which would be satisfactory in ordinary times because it would give the government control of a certain proportion of the community's purchasing power, but which in this case is of less value because what is desired is to obtain practically the whole of the new purchasing power of the community. All this is well enough recognized today, and accounts for the strong effort that is being made by those in charge of the loan to interest the small investor and saver, making the enterprise truly national in the best sense of the term by getting practically the whole population interested in the bonds and disposed to pay for them through a process of saving. Of course this will imply some effort on the part of the banks to carry the bonds during the time when purchasers need assistance in anticipation of their savings or wages and are therefore obliged to resort to the banks for temporary accommodation. This, however, is an enlargement of bank credit which may be regarded as temporary and consequently not of a dangerous variety.

RATES OF INTEREST AND THEIR EFFECT

The fact that the bonds have been rated at $3\frac{1}{2}$ per cent and have been made non-taxable has led to a great deal of criticism in many quarters. Analysis shows, however, that this question of rate is a very difficult and two-sided question. Had the bonds been placed at the current or market rate of interest—say 5 per cent—and been made subject to taxation, they would, it is argued, have appealed much more strongly to the small saver and investor. If asked today to take a government bond at $3\frac{1}{2}$ per cent the investor naturally casts a regretful eye toward sound privately issued securities which offer him 5 or 6 per cent. Exemption from taxation is of no particular value to him because he is not subject to the higher ranges of the income tax, hence has not a very important interest in exemption provisions. The terms of the loan are therefore said to be such as to appeal strongly to the wealthier classes in the community, which is disposed either to throw over its old investments, or to abstain from investments of this same type and to substitute the new bonds, because by so doing such investors will obtain a tax-free security whose income value may be nearly equal to that of the taxable bonds bearing higher rates. There is, however, as already intimated, another side of this situation. Had the new bonds been made to bear 5 per cent and to be subject to taxation from the outset, thus directly appealing to the small investor, he would in many cases have immediately withdrawn his funds from savings banks for the purpose of purchasing the new bonds. The savings banks would thereupon have been obliged to realize upon their securities in order to meet this type of demand—a call which they could have complied with only by actually selling the securities or by obtaining loans at banks with the securities as collateral. Had they followed either of these courses, the result would have been somewhat similar to that which is today being produced by the process of disposing of the securities held by the wealthier members of the community. Securities would have been placed on the market or bank credits would have been absorbed on the basis of these securities, as a result of action taken by savings banks and other institutions which would have found their clientèle leaving them in order to become investors in government bonds. Either way of handling the situation, therefore, almost inevitably results in a readjustment of values and a redistribution of ownership of securities.

REQUIREMENTS OF THE GOVERNMENT

The question how long the present borrowing plan will supply the funds needed is much under discussion, but can be readily answered from the figures already made known. Apparently the government has been financing the Allies at the rate of about $400,000,000 per month, with some prospect of raising this rate to $600,000,000 for a time. It has itself undertaken expenses for its own purposes which were estimated at $3,000,000,000 originally, but have now climbed to a figure in the neighborhood of $4,000,000,000 per annum. It being assumed that matters will proceed at their present rate, it would appear that the effort must be made to supply something like $800,000,000 each month. Should this prove to be more than the actual surplus of production over consumption, even with the surplus augmented by increasing economy on the part of all classes, the result would be as already forecast. Should the sum needed prove to be only approximately equal to the surplus within the country, the process of obtaining it would still be a matter of extensive adjustment and rearrangement. With taxation enacted to the extent of, say, $2,000,000,000 a year, it would seem that the proceeds from the loan now planned, amounting to $2,000,000,000, would not last more than from four to five months. This would mean that fresh loan operations of a similar proportion must be undertaken before the end of that time. The country has, in other words, embarked upon a process of extracting from itself about all that it can currently surrender, and this process will become more and more severe in effect as time goes on, and as the current surplus of production becomes more and more closely withdrawn or taken up. Opinions differ regarding the effect of the process upon production and trade, but there need be comparatively little variation of view on that score. The undertaking now in process inevitably means a speeding up of productive machinery to the highest point in certain industries, and the curtailment of the operation of other industries as the result of taxation or lack of demand for their output. We must, in short, expect to see a gradual, although sure, concentration of demand upon the output of comparatively few industries, and a compression of the demand for the product of others. This process will necessarily mean suffering and readjustment over a longer or shorter period, but extreme activity in every line that produces the goods that are in demand. High wages, profits, and interest are to be expected, while taxation will probably be far higher in proportion to normal levels than any of these, and prices higher still. Government control as a guiding element is already being extensively introduced into many economic fields, but the possibility of ultimately beneficial effects from its use is as uncertain here as in Europe, with the additional factor of discouragement that European experience in connection with it has already broken down.

THE PROGRAM OF TAXATION

It is too early as yet to speak definitely of the plans of taxation which are to accompany the new borrowing program. At the outset two methods of dealing with this subject were suggested, the one that of beginning the contest with resources largely derived from the sale of bonds, the other that of imposing taxation without delay to an amount as great as the general public could be induced to bear. The latter policy is the one that has been adopted by leaders in Congress, and economists have indulged in much vague discussion about what is called "conscription of income." This is all based upon the accepted and axiomatic principle that it is desirable to obtain the necessary funds for the maintenance of the war as much as possible from taxation and as little as possible from borrowing. Since the evident necessities of the case will call for the contribution, either by taxation or by borrowing, of practically the whole surplus of the country, as already seen, the question whether it is obtained through loans or taxation assumes a relatively minor place, granting sound management of the banking mechanism. The difficulty of the problem lies in the fact that the psychological effect of taxation is very different from that of public borrowing, while the direct business effects are likely to be injurious unless the tax provisions are worked out with great care.

In reporting an unprecedentedly large program of taxation, the House Ways and Means Committee (H.R. 4280) has proposed a measure which may possibly tend to restrict the successful placing of the great loans now in prospect. The adoption of the plan of waiting for the passage of the taxation measure until after the first loan had succeeded and the war requirements were better recognized, would, it is thought by capable observers, probably have been the wiser plan; or, if such a measure were to be proposed at once, it would have been better to have begun it upon a more limited scale in order to give less cause for discouragement and anxiety to prospective taxpayers. Special criticism has been offered in many quarters upon the plan of back-dating the new income tax. But, as already stated, it is too early as yet to reach a definite conclusion about the scope or the final effects of the new taxation, inasmuch as the measure will necessarily pass through many legislative changes before it reaches the statute books. In its present stage it is of interest chiefly as a factor in the general fiscal program, and as having, therefore, a distinct bearing upon the placing of the new bond issues.